THE ECONOMIC AND BUDGET OUTLOOK: AN UPDATE

A Report to the
Senate and House
Committees on the Budget

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The Congress of the United States
Congressional Budget Office

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NOTES

Unless otherwise indicated, all years referred to in Chapter I are calendar years and all years in Chapter II are fiscal years.

"Growth during 1988" or "growth in 1988" means growth from the end of 1987 to the end of 1988 except where otherwise specified. "Growth between 1987 and 1988" means the percentage difference between the annual average levels in 1987 and 1988.

Unemployment rates throughout the report are calculated on the basis of the civilian labor force.

Details in the text and tables of this report may not add to totals because of rounding.

In figures showing periods of recession, shaded areas indicate the months between cyclical peaks (P) and recession troughs (T).

The Balanced Budget and Emergency Deficit Control Act of 1985 (popularly known as Gramm-Rudman-Hollings) is also referred to in this volume more briefly as the Balanced Budget Act. The Balanced Budget and Emergency Deficit Control Reaffirmation Act of 1987 refers to amendments passed in late 1987 and is referred to in this volume more briefly as the Balanced Budget Reaffirmation Act.

In Chapter I of this report, the 10-year constant-maturity bond rate is referred to briefly as the 10-year bond rate.

PREFACE

This volume is one of a series of reports on the state of the economy and the budget issued periodically by the Congressional Budget Office (CBO). In accordance with CBO's mandate to provide objective and impartial analysis, the report contains no recommendations.

The analysis of the economic outlook presented in Chapter I was prepared by CBO's Fiscal Analysis Division under the direction of Frederick C. Ribe and Robert A. Dennis, with the assistance of Victoria S. Farrell, and George R. Iden. The analysis was carried out by Trevor Alleyne, Douglas R. Hamilton, James Kiefer, Angelo Mascaro, Stephen Miller, John F. Peterson, Frank S. Russek, Jr., John Sabelhaus, Matthew A. Salomon, John R. Sturrock, and Stephan S. Thurman. Research assistance was provided by Jeanne Dennis, Nicholas Dugan, Patricia Phill, and Bragi Valgeirsson.

The baseline outlay projections were prepared by the staff of the Budget Analysis Division under the supervision of James L. Blum, C.G. Nuckols, Michael Miller, Charles Seagrave, Robert Sunshine, and Paul N. Van de Water. The revenue estimates were prepared by the staff of the Tax Analysis Division under the direction of Rosemary D. Marcuss and Kathleen M. O'Connell. Principal staff contributors are listed in Appendix C.

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Acting Director

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SUMMARY

The American economy, now in its sixth year of expansion, grew at a 3.3 percent clip during the first half of 1988. The continued strength of the expansion has improved the budget outlook. The Congressional Budget Office (CBO) projects that the federal deficit under current budgetary policies will fall from $155 billion in 1988 to $148 billion in 1989, $136 billion in 1990, and $121 billion in 1993 and 1994.

THE BUDGET OUTLOOK

In CBO's winter report, the federal deficit was projected to rise in 1988 and 1989. But because of unexpectedly strong economic growth in the past six months, the deficit is now projected to remain relatively flat in 1988 and 1989 and to fall slowly thereafter. In relation to the size of the economy, the deficit declines from 3.4 percent of gross national product (GNP) in 1987 to 1.7 percent of GNP in 1994, as shown in the Summary Figure.

Deficit Projections and Targets

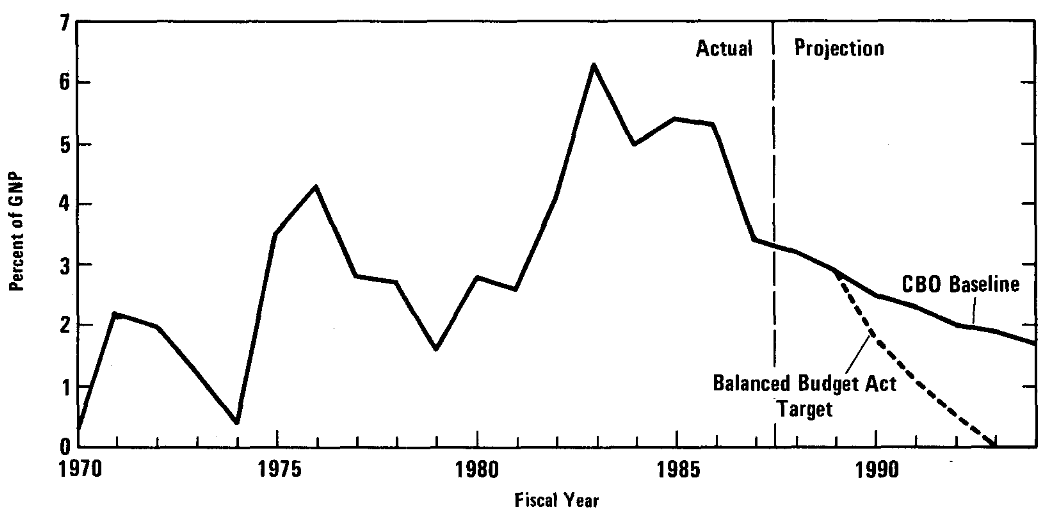
The Balanced Budget and Emergency Deficit Control Reaffirmation Act of 1987 (Public Law 100-119) set new deficit targets and modified the automatic spending reduction, or sequestration, procedures of the Balanced Budget Act of 1985 (Public Law 99-177). For 1989, the deficit target is $136 billion. If the estimated deficit exceeds $146 billion ($136 billion plus a $10 billion margin of error), it will trigger across-the-board cancellation of budgetary resources.

CBO's 1989 baseline deficit projection includes $5 billion in receipts from loan prepayments, which may not be counted toward meeting the Balanced Budget Act target. Excluding these receipts, the projected deficit is $153 billion, which exceeds the sequestration threshold by $7 billion and the deficit target by $17 billion. But CBO's deficit estimate plays no part in triggering automatic spending cuts.

The Balanced Budget Reaffirmation Act gives CBO only an advisory role in the sequestration process. Under the terms of the act, the Director of the Office of Management and Budget (OMB) alone determines whether or not automatic spending cuts are necessary and how large the cuts must be. In its July 28 *Mid-Session Review of the 1989 Budget*, OMB estimated that the 1989 base deficit for purposes of the Balanced Budget Act is $140.1 billion. According to OMB, the Disaster Assistance Act (Public Law 100-387), signed by the President on August 11, has added $3.9 billion to that amount. As a result, OMB's deficit estimate is expected to remain below the $146 billion threshold for its initial sequestration report. The differences between the CBO and OMB deficit estimates stem from different expectations about the economy and from various technical estimating differences.

For 1990, the Balanced Budget Act deficit target is $100 billion, and the deficit must be held below $110 billion to avoid sequestration. Last winter, when CBO's 1990 baseline deficit projection was $170 billion, this goal seemed very difficult to reach. Today, with CBO's baseline deficit at $136 billion, the 1990 target appears more attainable.

Summary Figure.
Budget Deficits and Targets



SOURCE: Congressional Budget Office.

Social Security and the Budget

The slow decline in the total deficit comprises very different trends in its on- and off-budget components, as shown in Summary Table 1. Between 1988 and 1994, the on-budget deficit grows from $194 billion to $234 billion, while the off-budget Social Security surplus increases from $39 billion to $113 billion. Economists and financial market participants generally focus on the total deficit, because it both determines federal borrowing needs and affects economic activity. The targets contained in the Balanced Budget Reaffirmation Act are also expressed in terms of the total deficit. Nevertheless, the Balanced Budget Act of 1985 took off-budget the two Social Security cash benefit trust funds, Old-Age and Survivors Insurance and Disability Insurance (OASDI).

SUMMARY TABLE 1. BASELINE DEFICIT PROJECTIONS AND TARGETS (By fiscal year)

	Actual 1987	Estimate 1988	Projections 1989	1990	1991	1992	1993	1994
In Billions of Dollars								
Baseline Projections								
On-budget deficit	170	194	199	199	206	212	220	234
Off-budget surplus[a]	20	39	52	63	74	86	99	113
Total deficit	150	155	148	136	131	126	121	121
Deficit Targets	b	144	136	100	64	28	0	b
As a Percentage of GNP								
Baseline Projections								
On-budget deficit	3.8	4.1	3.9	3.7	3.6	3.4	3.3	3.3
Off-budget surplus[a]	0.4	0.8	1.0	1.2	1.3	1.4	1.5	1.6
Total deficit	3.4	3.2	2.9	2.5	2.3	2.0	1.8	1.7
Deficit Targets	b	3.0	2.7	1.8	1.1	0.5	0	b

SOURCE: Congressional Budget Office.

a. Social Security (Old-Age and Survivors Insurance and Disability Insurance Trust Funds).

b. The Balanced Budget and Emergency Deficit Control Reaffirmation Act of 1987 established targets for 1988 through 1993.

Because payroll and other earmarked taxes now exceed outlays for Social Security benefits and administrative costs, Social Security is contributing to reducing the total federal deficit. An increasing portion of the Social Security surplus, however, results from interest income earned on the growing trust fund balances, which are invested in government securities. The interest income of the Social Security trust funds does not reduce the total deficit, because the interest earnings of the trust funds are also on-budget interest outlays of the U.S. Treasury.

Changes in Projections

Summary Table 2 categorizes the changes in CBO's deficit projections since last winter. The improvement stems entirely from stronger-than-expected economic growth in 1988 and from a higher estimate of the economy's long-run growth potential. The change in the economic outlook reduces the projected deficits by $22 billion in 1988, an average of $35 billion per year in 1989 through 1992, and $23 billion in 1993.

SUMMARY TABLE 2. CHANGES IN BASELINE DEFICIT PROJECTIONS SINCE MARCH 1988 (By fiscal year, in billions of dollars)

	1988	1989	1990	1991	1992	1993
Winter Baseline	161	177	170	159	154	139
Changes:						
Enacted legislation	a	5	-1	a	a	a
Updated economic assumptions	-22	-35	-37	-34	-32	-23
Technical reestimates	15	a	5	6	5	5
Total Changes	-6	-29	-34	-28	-28	-18
Summer Baseline	155	148	136	131	126	121

SOURCE: Congressional Budget Office.

a. Less than $500 million.

Changes in technical estimating assumptions have increased projected outlays and the deficit in all years except 1989. This pattern reflects in part an expected delay in the refinancing of foreign military sales loans, which increases outlays by $3 billion in 1988 and reduces them by the same amount in 1989. Estimated spending for national defense and for deposit insurance has increased, while higher projected farm prices have reduced federal price and income support payments for farmers. Revenues have been revised downward every year to reflect a persistent shortfall in corporate income tax receipts.

Enacted legislation adds to the projected deficit by $5 billion in 1989 but has little effect in other years. CBO estimates that the Disaster Assistance Act will cost $5.1 billion in 1989. The Medicare Catastrophic Coverage Act (Public Law 100-360) marks the largest expansion of Medicare benefits since the program began; it is financed through increases in premiums and income taxes, however, and actually reduces the projected deficits slightly in the short run. Other recent legislation has had little effect on the budget totals.

ECONOMIC ASSUMPTIONS

The economy has grown more rapidly in the first half of 1988 than CBO and other forecasters previously expected. As a result, CBO's new forecast shows substantially stronger growth for 1988 as a whole than was projected last winter. CBO has also increased its estimate of the rate of growth of potential output. The projected level of the gross national product is therefore higher every year than it was in CBO's winter baseline.

Forecast for 1988 and 1989

In the wake of last October's stock market collapse, many forecasters expected that a reduction of inventory accumulation and a weakness in consumption would lead to a slowing in growth. But the slowdown did not materialize.

During the first half of 1988, real GNP grew at a 3.3 percent annual rate. Virtually all of the growth in final sales came from exports and from business investment in plant and equipment. In CBO's short-term economic forecast for 1988 and 1989, net exports and business fixed investment are assumed to continue as the main sources of growth, though they grow more slowly than in the first half of 1988.

In the CBO forecast, the economy grows at a 2.5 percent average annual rate over the next 18 months. With the current low rate of unemployment and high rate of use of plant capacity, substantially faster growth than this is likely to cause rising inflation. On the other hand, actions by the Federal Reserve to raise interest rates and moderate growth could halt the reduction in the U.S. trade deficit and unintentionally produce a sharp economic slowdown. Further reductions in the budget deficit would help improve the trade deficit and ease the dilemma, but current policies produce little fiscal restraint in 1989.

The Federal Reserve's policy of moderate monetary tightening, begun in March, causes short-term interest rates to rise. This policy is assumed to be successful in limiting the growth in demand enough to avoid a sharp increase in inflation. Consumer prices nevertheless increase moderately faster in 1989 than in 1988 because of drought-related increases in food prices and, to a lesser extent, because of higher import prices. With growth near the estimated 2.7 percent growth rate of potential output, the unemployment rate stays at about 5½ percent. CBO foresees less real growth in 1989 than the Administration but more than the average of private-sector forecasts (see Summary Table 3). CBO's forecasts for inflation and interest rates are higher than the Administration's but close to the *Blue Chip* consensus.

Projections for 1990 through 1994

Beyond 1989, CBO's economic assumptions are not a forecast of future conditions but are projections based on past trends. In the projections, real GNP grows at an average annual rate of 2.3 percent in 1990 through 1994, and the civilian unemployment rate remains close to current levels. Because the projections are based on historical averages, they are consistent with the occurrence of one mild recession over the next six years.

SUMMARY TABLE 3. CBO, ADMINISTRATION, AND *BLUE CHIP* SHORT-RUN ECONOMIC FORECASTS
(By calendar year)

	1987[a]	Forecast 1988	1989
Fourth Quarter to Fourth Quarter (Percent change)			
Real GNP			
CBO	5.0	2.6	2.7
Administration	4.0	3.0	3.3
Blue Chip	5.0	3.0	1.9
Nominal GNP			
CBO	8.3	6.4	7.0
Administration	7.4	6.6	7.1
Blue Chip	8.3	6.6	6.3
Consumer Price Index			
CBO[b]	4.5	4.4	5.0
Administration[b]	4.6	4.2	3.9
Blue Chip[c]	4.5	4.4	5.0
Calendar-Year Averages (Percent)			
Three-Month Treasury Bill Rate			
CBO	5.8	6.3	7.1
Administration	5.8	6.0	5.5
Blue Chip	5.8	6.5	7.0
Ten-Year Government Note Rate[d]			
CBO	8.4	8.9	9.1
Administration	8.4	8.5	8.1
Blue Chip	8.4	8.9	8.9
Civilian Unemployment Rate[e]			
CBO	6.2	5.5	5.5
Administration	6.1	5.5	5.2
Blue Chip	6.2	5.5	5.5

SOURCE: Congressional Budget Office; Office of Management and Budget; Eggert Economic Enterprises, Inc., *Blue Chip Economic Indicators* (August 10, 1988).

a. The national income data for 1987 were revised in July. The CBO and *Blue Chip* forecasts incorporate that revision, but the Administration forecast was prepared before the revision.

b. Consumer Price Index for urban wage earners and clerical workers.

c. Consumer Price Index for all urban consumers.

d. *Blue Chip* does not project a 10-year note rate. The values shown here are based on the *Blue Chip* projection of the AAA bond rate adjusted by CBO to reflect the estimated spread between AAA bonds and 10-year government notes.

e. The Administration's projection is for the total labor force, including armed forces residing in the United States, while the CBO and *Blue Chip* projections are for the civilian labor force excluding armed forces. In recent years, the unemployment rate for the former has tended to be 0.1 to 0.2 percentage point below the rate for the civilian labor force alone.

Summary Table 4 presents CBO's new economic projections and compares them with those of last winter. Because population trends will slow the growth of the labor force, the projected GNP growth for 1990 through 1994 is somewhat slower than the forecast for 1988 and 1989. Growth is also less than projected last winter, since the economy is now operating closer to full capacity. Despite the reduction in

SUMMARY TABLE 4. CBO SUMMER AND WINTER ECONOMIC PROJECTIONS (By calendar year)

		Forecast		Projections				
	1987	1988	1989	1990	1991	1992	1993	1994
GNP (Billions of current dollars)								
Summer	4,527	4,844	5,189	5,525	5,882	6,263	6,670	7,103
Winter	4,486	4,744	5,068	5,414	5,782	6,179	6,606	a
Real GNP Growth (Percent change)								
Summer	3.4	3.8	2.7	2.3	2.3	2.3	2.3	2.3
Winter	2.9	2.3	2.6	2.6	2.6	2.7	2.7	a
Implicit GNP Deflator (Percent change)								
Summer	3.3	3.1	4.3	4.1	4.1	4.1	4.1	4.1
Winter	3.0	3.4	4.1	4.1	4.1	4.1	4.1	a
Unemployment Rate (Percent)								
Summer	6.2	5.5	5.5	5.5	5.6	5.6	5.7	5.7
Winter	6.2	6.2	6.1	6.0	5.9	5.9	5.8	a
CPI-W (Percent change)								
Summer	3.6	4.1	4.9	4.6	4.4	4.4	4.4	4.4
Winter	3.6	4.5	4.9	4.6	4.4	4.4	4.4	a
Three-Month Treasury Bill Rate (Percent)								
Summer	5.8	6.3	7.1	6.8	6.6	6.3	6.1	5.9
Winter	5.8	6.2	6.7	6.6	6.4	6.1	5.9	a
Ten-Year Government Note Rate (Percent)								
Summer	8.4	8.9	9.1	8.7	8.3	8.0	7.6	7.4
Winter	8.4	9.3	9.5	9.0	8.4	7.8	7.4	a

SOURCE: Congressional Budget Office.

a. The Congressional Budget Office winter projections extended only through 1993.

the long-run growth rate, however, the higher growth rate in 1988 and an increase in the estimated growth rate of potential output causes the level of GNP to exceed CBO's previous projections in all years.

The long-run inflation and interest-rate assumptions differ little from those underlying CBO's winter baseline. The inflation rate as measured by the GNP deflator is projected to remain constant at an annual rate of 4.1 percent, close to the postwar average. The Consumer Price Index (CPI) grows slightly more rapidly, at 4.4 percent a year, because the CPI includes import prices, which are projected to rise, and excludes computer prices, which are going down. The three-month Treasury bill rate declines throughout the projection period until it reaches 5.9 percent--a level consistent with the average of real short-term rates since exchange rates began floating in 1973. Similarly, the 10-year government note rate declines until it reflects the average spread between short- and long-term rates.

While CBO's long-run economic projections are not based on any particular fiscal policy, the persistence of large budget and trade deficits together with low personal saving may make it difficult to reduce real interest rates to their historical averages. The declining interest-rate path assumed in the projections may be unachievable without reducing the federal deficit below the levels shown in CBO's baseline budget projections.

CHAPTER I

THE ECONOMIC OUTLOOK

The economy improved on several fronts during the first half of 1988: production expanded at a healthy pace, the merchandise trade deficit declined, and the unemployment rate fell to its lowest level since the early 1970s. The continuing strength of the expansion surprised many forecasters, including the Congressional Budget Office (CBO). These forecasters had thought that the October stock market crash, inventory accumulation, and other developments late last year would lead to a temporary slowdown in growth.

The current expansion has now gone on for five and a half years, making it the second longest on record in the postwar period. Moreover, encouraging signs are developing of a shift in the sources of economic growth--away from personal consumption and government purchases and toward business investment and exports--that should help sustain the expansion.

There are, however, reasons for concern about the short-term economic outlook--namely, the danger of an upsurge of inflation, and the possibility that restrictive policies to control inflation may halt the progress that has been made in reducing the trade deficit and cause a severe economic slowdown. Strong economic expansion has tightened labor and product markets so much that, unless growth slows down, the pressures are likely to force inflation upward. The Federal Reserve has raised interest rates to slow economic growth, but many analysts would prefer to see a tighter fiscal policy--that is, more effort to reduce the federal budget deficit--since this would permit lower interest rates. The dollar's rise this year may already have slowed the decline in the trade deficit, and higher interest rates may have been a contributing factor. Whether economic growth is restrained with monetary or with fiscal policy, however, there is a risk of unintentionally going too far and causing a recession.

Some analysts, on the other hand, are optimistic. A number of economic indicators suggest that inflation will not rise in spite of the drought and the low unemployment rate. Thus, policy may not need to be so restrictive in the future, and the economy could be allowed to grow faster.

CBO's short-term economic forecast for the remainder of 1988 and for 1989 lies between these pessimistic and optimistic extremes: it assumes there will be continued economic expansion, though at rates slightly below those of recent months, and a moderate near-term increase in inflation (see Figure I-1). Interest rates are anticipated to continue rising moderately over the next several months before leveling off. Gradual improvement in net exports helps to buoy the dollar for several more months, but eventually the exchange rate returns to a depreciating trend.

As background for a detailed presentation of the economic outlook, the first section of this chapter provides an analysis of fiscal and monetary policies in 1987 and early 1988. The second section analyzes the outlook for inflation, while the third section discusses important sources of economic growth during the first half of 1988, and how they can be expected to change during the forecast period. The chapter concludes with the economic forecast.

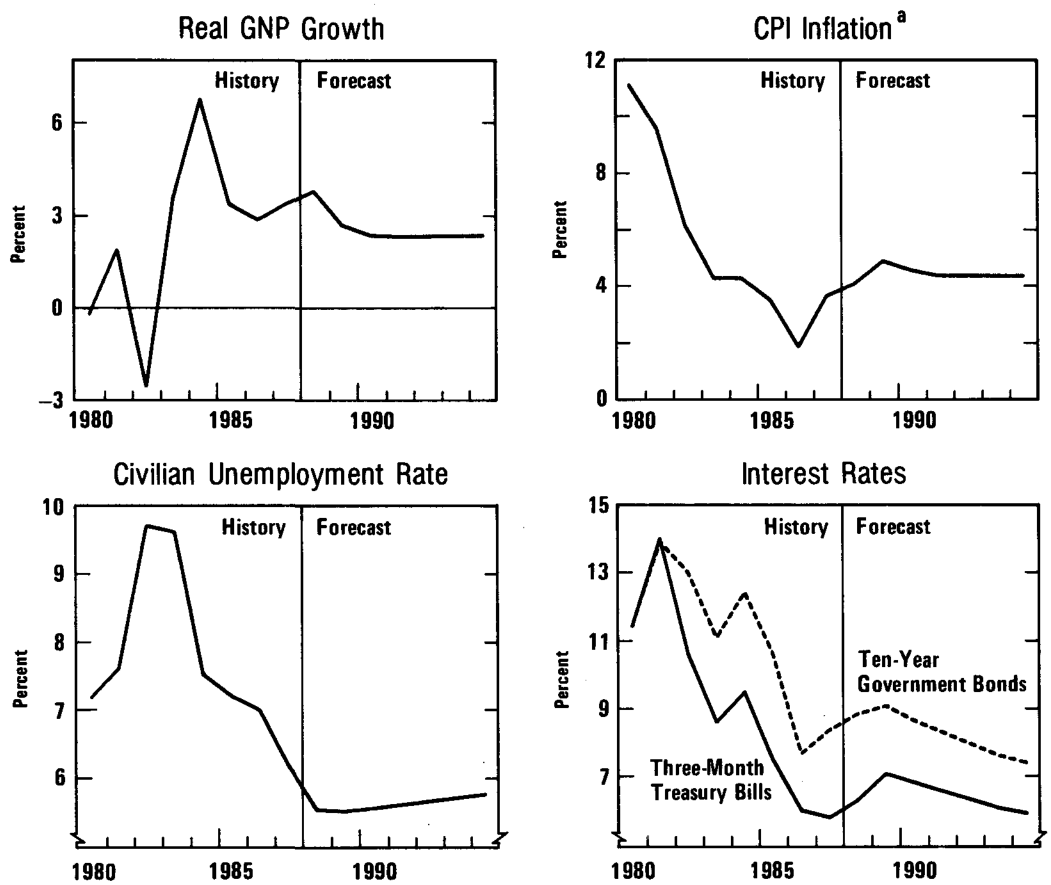
FISCAL AND MONETARY POLICY

The Congress and the Administration can affect overall domestic saving through fiscal policy--changes in federal spending and tax rules. Increasing saving by reducing the budget deficit helps slow the expansion of overall domestic demand, and is called "tight" or "restrictive" fiscal policy for that reason. The Federal Reserve, for its part, can manipulate economic growth through monetary policy--changes in short-term interest rates and monetary aggregates. A restrictive monetary policy comes about through increases in rates and slowing of money growth. Monetary policy can also affect the level of the dollar by carefully coordinating changes in interest rates with those in other countries, and by buying and selling dollars in foreign-exchange markets--usually in coordination with other central banks.

Fiscal and monetary policies in 1987 and early 1988 have played an important role in restraining domestic consumption, stabilizing the economy after the stock market crash, and promoting gradual depreciation of the dollar. The policy outlook at midyear 1988, however, presents new complications: the danger of increased inflation has be-

Figure I-1.

The Economic Forecast and Projections



SOURCES: Congressional Budget Office; Department of Commerce, Bureau of Economic Analysis; Federal Reserve Board.

a. CPI-U from January 1983 to present; before that time the series incorporates a measure of homeownership conceptually similar to that of the current CPI-U.

come more immediate, while the depreciation of the dollar has been interrupted and partially reversed, threatening to halt recent declines in the trade deficit. Additional restraint by both monetary and fiscal policy may be needed to contain inflationary pressures and permit recent declines in the trade deficit and growth in business investment to continue. But monetary and fiscal policies are blunt instruments, and there is an inherent danger that restraint by either policy--while necessary to control inflation--may go too far, especially if export growth should slow unexpectedly.

Fiscal Policy

CBO's estimates of the federal deficit for 1988 and 1989 under present policies are roughly constant at about $150 billion. As Chapter II points out, these estimates are generally lower than those made by CBO last winter, largely because economic growth since then has been stronger than expected. The current estimates show a sharp decline in the absolute size of the deficit from the levels it reached a few years ago, and an even sharper decline in the deficit as a percentage of gross national product (GNP). The deficit continues to decline as a share of GNP during the current period, because GNP itself is growing. Until this year, however, the fall in the deficit relative to GNP has not been reflected in an increase in the country's saving; in fact, the improvement in the federal deficit has been more than offset by a decline in private saving (see Table I-1).

The Balanced Budget Act. The Balanced Budget Reaffirmation Act of 1987 mandates automatic spending cuts to reach a deficit target of $136 billion for 1989. As Chapter II points out, however, no such cuts are expected in 1989 even though CBO's baseline estimates are above the level intended to trigger the automatic reductions. This is because the cuts are determined on the basis of deficit estimates by the Office of Management and Budget (OMB), which are expected to be below the triggering level for 1989. For 1990 and later years, however, efforts to reach the deficit targets in the Balanced Budget Reaffirmation Act may well reduce the deficit below CBO's baseline.

Implications of the Deficit for the Economic Outlook. The short-term impact of the deficit on domestic demand is best measured, not by the deficit figures given above, but by estimates of the "structural" or "standardized-employment" deficit expressed as a percentage of potential GNP. The standardized-employment deficit is the deficit adjusted for the effects of cyclical changes in the economy that do not reflect deliberate fiscal policy actions. In its most useful version, the standardized-employment deficit incorporates adjustments for asset sales and shifts in the timing of revenues and outlays that do not affect domestic demand in the short run.

Estimates of the yearly changes in the standardized-employment deficit incorporating these adjustments are shown in Table I-2. (The

TABLE I-1. NET SAVING FLOWS AS A PERCENTAGE OF GNP (National income basis)

	(1) Net Private Domestic Saving	(2) State and Local Surplus[b]	(3) Federal Surplus[b]	(4) Net Domestic Saving (1) + (2) + (3)
1950-1959	7.5	-0.2	0.1	7.4
1960-1969	8.1	0.0	-0.3	7.9
1970-1979	8.1	0.8	-1.7	7.1
1980-1987	5.8	1.3	-4.0	3.1
1980	6.4	1.0	-2.2	5.1
1981	6.6	1.1	-2.1	5.7
1982	5.5	1.1	-4.6	2.0
1983	5.7	1.4	-5.2	2.0
1984	6.8	1.7	-4.5	4.1
1985	5.7	1.6	-4.9	2.4
1986	5.3	1.4	-4.8	1.9
1987	4.1	1.2	-3.5	1.8
1988[a]	4.6	1.1	-2.9	2.8

SOURCES: Congressional Budget Office; Department of Commerce, Bureau of Economic Analysis.

a. An estimate for the first half of 1988 based on available data.

b.. Minus sign indicates deficit.

corresponding levels are shown in Figure I-2.) The measure is projected to decline less in 1988 and 1989 than it did in 1987, suggesting a decline in fiscal restraint.

The Longer-Term Budget Outlook. CBO's baseline projections imply that, under current policies, the federal deficit will decline gradually as a percentage of GNP after 1989, from 2.5 percent in 1990 to 1.7 percent in 1994. But if the targets in the Balanced Budget Reaffirmation

TABLE I-2. CHANGES IN THE STANDARDIZED-EMPLOYMENT DEFICIT (By fiscal year, on a budget basis)

	1987	1988	1989	1990	1991	1992	1993	1994
				Changes in Billions of Dollars				
Baseline Standardized-Employment Deficit	-68	32	-3	-14	-8	-8	-8	3
Adjusted for tax reform and other special factors	-34	-12	-6	-6	-1	-8	-9	-5
Standardized-Employment Deficit Reflecting Balanced Budget Act Targets[a]	-68	32	-3	-50	-39	-39	-31	n.a.
				Percentage-Point Changes in Deficit Measures as a Percentage of Potential GNP				
Baseline Standardized-Employment Deficit	-1.7	0.5	-0.3	-0.4	-0.3	-0.3	-0.3	-0.2
Adjusted for tax reform and other special factors	-1.0	-0.4	-0.3	-0.3	-0.2	-0.3	-0.3	-0.2
Standardized-Employment Deficit Reflecting Balanced Budget Act Targets[a]	-1.7	0.5	-0.3	-1.1	-0.8	-0.7	-0.5	n.a.

SOURCE: Congressional Budget Office.

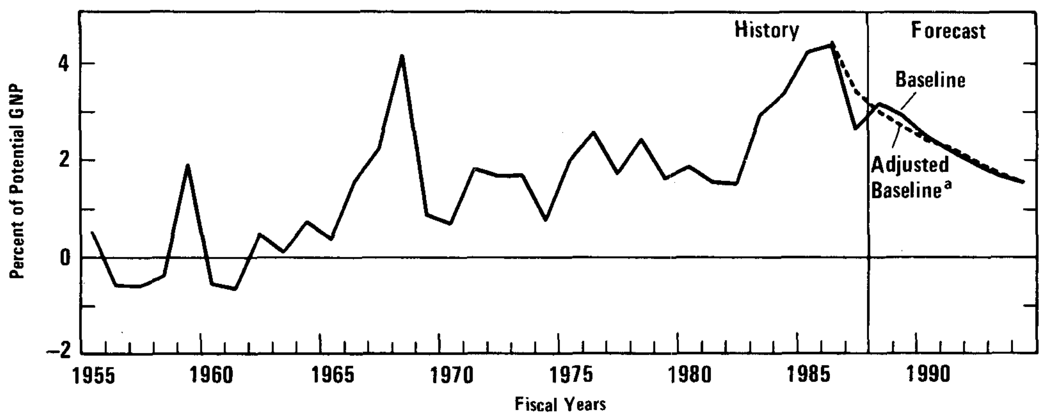
NOTES: A negative sign indicates fiscal restraint--that is, a movement toward a smaller deficit.
n.a. = not applicable.

a. These calculations are estimates of the standardized-employment deficit based on the current CBO baseline economic projections. They assume full implementation of whatever deficit reductions are needed to achieve the budget targets for 1990 through 1993 set forth in the Balanced Budget and Emergency Deficit Control Reaffirmation Act of 1987. No adjustments are made for the nonrecurring effects of the 1986 Tax Reform Act and other special factors.

Act are met, the deficit would decline to 1.8 percent of GNP in 1990 and be eliminated in 1993. Under baseline assumptions, CBO projects that the federal debt will increase slightly from 42.6 percent of GNP in 1988 to 42.7 percent in 1989 before declining to 40.1 percent in 1994. The projected decline in the debt/GNP ratio is distinctly sharper under the Balanced Budget Act's targets, as Figure I-3 shows.

Figure I-2.

The Standardized-Employment Deficit

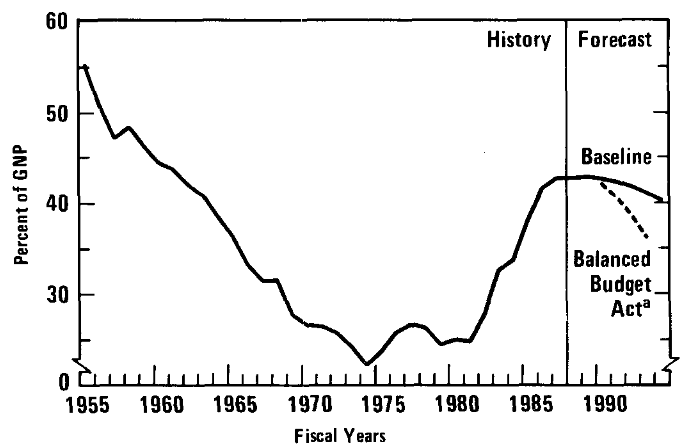


SOURCE: Congressional Budget Office.

[a] Adjusted for tax reform and other special factors.

Figure I-3.

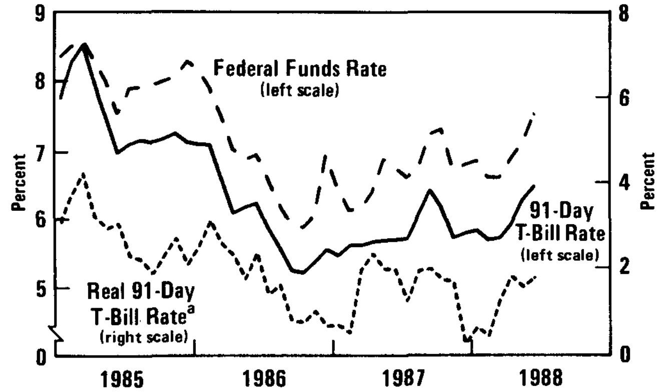
Publicly Held Federal Debt



SOURCES: Congressional Budget Office; Department of Commerce, Bureau of Economic Analysis.

[a] See footnote a, Table I-2.

Figure I-4.
Short-Term Interest Rates



SOURCES: Congressional Budget Office; Federal Reserve Board; Department of Labor, Bureau of Labor Statistics.

a The real 91-day Treasury-bill rate is the nominal rate less the annual rate of inflation over the next three months as measured by the Consumer Price Index.

Monetary Policy, Interest Rates, and the Dollar

Monetary restraint has been increasingly evident since March of this year, as reflected in rising short-term interest rates, and to a lesser extent in the recent strength of the dollar.[1]

Interest Rates and the Dollar. Short-term interest rates remained near their relatively low post-crash levels during the first quarter of 1988 (see Figure I-4), while the estimated real Treasury bill rate (the nominal rate minus the current rate of inflation) was well below pre-crash levels. However, the Federal Reserve tightened its policy between late March and August, in part through a 0.5-percentage-point increase in the discount rate, as signs appeared that economic growth was accelerating. Short-term interest rates rose by over one percentage point between early April and mid-August, putting them at the levels they had reached before the stock market crash. Long-term rates also rose over this period, and the stock market recovered.

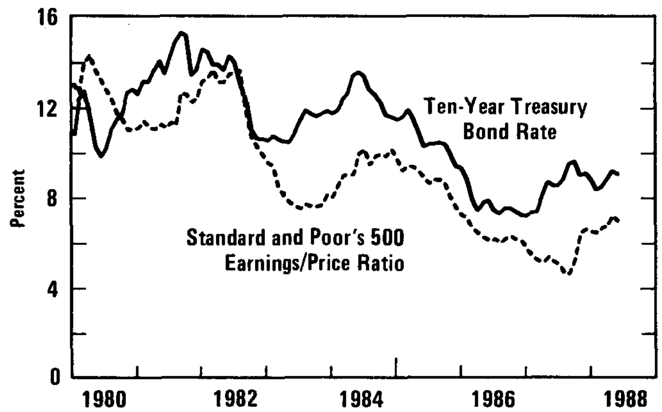
Developments in the stock and bond markets during the first half of 1988 were superficially reminiscent of those a year earlier, but the large discrepancy between movements in bond and equity prices that played an important role in the October stock market crash does not

1. For an extensive discussion of recent monetary policy, see *Monetary Policy Report to Congress Pursuant to the Full Employment and Balanced Growth Act of 1978* (Washington, D.C.: The Federal Reserve Board, July 13, 1988).

seem to have developed. The stock market rise has been accompanied by an increase in dividends and earnings, so that yields have not fallen as they did last spring and summer (see Figure I-5).

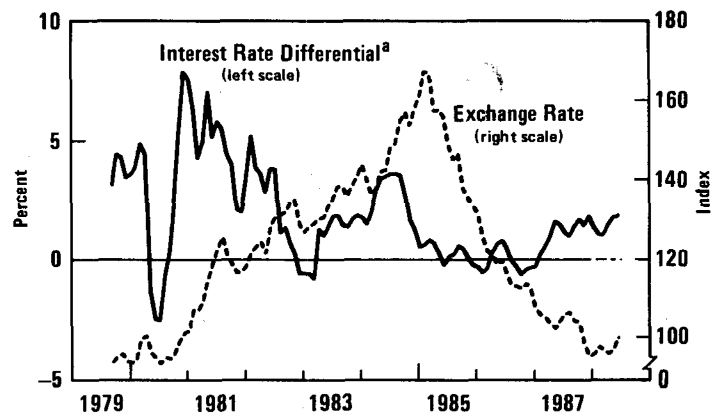
Interest-rate differentials with other countries narrowed during the first quarter, as U.S. and foreign central banks sought to accommodate demands for liquidity in the wake of the stock market crash. Nevertheless, the dollar remained firm because of massive support by U.S. and foreign central banks (see Figure I-6). Interest-rate differ-

Figure I-5.
Bond and Equity Yields



SOURCES: Congressional Budget Office; Standard and Poor's Corporation; Federal Reserve Board.

Figure I-6.
Interest Rates and the Exchange Rate



SOURCES: Congressional Budget Office; Federal Reserve Board; Data Resources, Inc.

a. Treasury-bill rate relative to a five-country average of three-month Eurodollar rates.